California Public Employees' Retirement System
Office of Governmental Affairs
P.O. Box 942720
Sacramento, CA 94229-2720
TTY: (916) 795-3240
(916) 795-3689 phone • (916) 795-3270 fax
www.calpers.ca.gov

Agenda Item 6a

May 16, 2011

TO: MEMBERS OF THE INVESTMENT COMMITTEE

I. SUBJECT: SB 294 (Price) – As Amended 3/24/2011
Emerging Investment Managers: Five Year Plan

II. PROGRAM: Legislation

III. RECOMMENDATION: Oppose, unless amended then Support, once amended

IV. ANALYSIS:

Summary

This bill would require the California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS) to provide five year strategic plans by August 1, 2012, to expand the participation of emerging investment managers across all asset classes. It also requires each System to report on their progress annually until January 1, 2018.

Background

Ongoing Efforts to Develop and Engage Emerging Investment Managers

The CalPERS Investment Office leverages the skills and ideas of all industry participants in order to maintain a competitive edge in the changing global markets. Achieving diversity in the area of investments contributes to the overall success of the pension fund while creating and supporting new opportunities in underserved markets. CalPERS is a leader among a handful of peers in the plan sponsor community with regard to inclusion of emerging firms, diverse talent and new skill sets.

CalPERS actively encourages participation by minority and women-owned, and new and emerging investment management firms by integrating services of specialist external program advisors and diversity investing consultants to enhance our portfolio management and research capabilities, and further external outreach efforts. CalPERS works with these business partners as well as non-profit educational and industry associations to engage in research briefings, host outreach events and participation in emerging manager and diversity conferences nationwide. Resource additions recently include the

CalPERS Investment Officer for Diversity Programs who provides yet another point of contact for emerging managers and a web-based submission process that allows any investment manager to present investment proposals directly to asset class Investment Office staff.

Diversity & Inclusion in Portfolio Management

The CalPERS Board of Administration (Board) has adopted several policies and investment programs to diversify its investments portfolio, which in turn, provides opportunities and resources for the investment industry as a whole. Furthermore, CalPERS Investment Office designs innovative investment programs. The Management Development Program (MDP) launched more than ten years ago allocates capital as well as invests directly in small and emerging public equity investment management firms in exchange for an equity stake. In 2007, CalPERS also established a series of emerging manager programs focused on hedge fund and private equity strategies.

CalPERS Diversity and Investment Reporting

Existing law requires CalPERS to annually report to the Legislature on the investment performance of all external investment managers, and the projected and actual fees paid them. In addition, CalPERS voluntarily produces an annual diversity report with key indicators in each of its specialized investment programs and external diversity outreach efforts on progress toward more diverse representation among the individuals and firms with whom we do business. It includes, among other information and data on participation in assets under management reported by asset class for emerging investment managers and diversity along gender, ethnicity and disabled veteran status. We gather this data through voluntary surveys of these firms. However, CalPERS cannot compel our external partners to respond to such requests. This report is reviewed with CalPERS Board of Administration, and thereafter distributed to interested members of the Legislature and Administration, and posted on the CalPERS website.

This annual report is not limited to emerging investment managers and does not define emerging managers in gender and ethnic terms. The various CalPERS investment programs define the term “emerging manager” differently for each asset class based on the strategic needs or requirements unique to each – be it the amount of assets under management or the characteristics of the investable pool of external money managers. In order for CalPERS to achieve long-term sustainable returns, each asset class is responsible for managing risk according to its own strategies, allocations, and definitions.

LEGISLATIVE HISTORY

2011 AB 17 (Davis) – Requires the CalPERS Board of Administration (Board) to annually report to the Legislature on the ethnicity and gender of its external investment managers and external firms that provide brokerage services. It would also require the Board to develop and include in the report plans and strategies to increase the participation of emerging investment managers and emerging brokerage firms, as defined. *CalPERS Position: Pending.*

2010 AB 1913 (Davis) – Would have required CalPERS and CalSTRS to report annually to the Legislature on or before January 1, 2012, and until January 1, 2016, information regarding the ethnicity and gender of emerging investment managers who manage retirement fund assets and the ethnicity and gender of the owners of investment management firms with retirement fund management contracts. The bill also would have required each board to develop and report plans and strategies to increase emerging investment manager participation in each fund's actively managed portfolio to ten percent. The AB 1913 language was based on model legislation in the State of Illinois. This bill died in the Senate Rules Committee. *CalPERS Position: Oppose, unless amended then Support, once amended.*

AB 1919 (Davis) – Would have required the CalPERS Board of Administration (Board) to annually report to the Legislature on the ethnicity and gender of its external investment managers and external firms that provide brokerage services. It also would have required the Board to develop and include in the report plans and strategies to increase the participation of emerging investment managers and emerging brokerage firms, as defined. This bill died in the Senate Rules Committee. *CalPERS Position: None.*

<u>Proposed Changes</u>

Specifically, this bill would:

- Require the CalPERS and CalSTRS Boards to provide by August 1, 2012, five year strategic plans to expand the participation of emerging investment managers across all asset classes.

- Require the plans to commence by August 1, 2012, and to include a 15 percent participation goal.

- Require each Board to submit a progress report to the Legislature on the plan's benchmarks commencing March 2014, and then each March, thereafter.

- Require each Board to define "emerging investment manager" by regulation.

- Sunset on January 1, 2018.

Issues

1. Arguments in Support

   The author states that SB 294 is intended to: "encourage expanded opportunities for newer and smaller investment companies in the State procurement of financial services, including the management of assets managed by the State's public pension funds."

   According to the author, "The bill specifies that the strategic plan shall include a 15 percent participation goal, relating to the management of the funds' total portfolio, for emerging managers, as defined by the public pension systems."

2. Arguments in Opposition

   There is currently no known opposition at this time.

3. Constitutional Authority and Fiduciary Responsibility Regarding Investments

   Article XVI, Section 17 of the California Constitution gives the boards of public retirement systems in California plenary authority and fiduciary responsibility for investment of pension assets and administration of the system. The Constitution expressly provides that the retirement board of a public pension fund shall have the sole and exclusive fiduciary responsibility over the assets of the public pension or retirement system. It further requires the fiduciary of the public pension or retirement system to discharge his or her duties solely in the interest of, and for the exclusive purpose of providing benefits to, participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system. The Constitution also requires the boards of public pension funds to diversify the investments of the systems so as to minimize the risk of loss and to maximize the rate of return, unless under the circumstances it is clearly not prudent to do so.

Except for divestment decisions made under specified conditions, the Constitution vests exclusive authority with public retirement boards regarding investment decisions and overseeing the execution of these decisions. This includes, among other things, any asset allocation strategies, selection of investment managers, or participation goals. By requiring the Board to establish a “plan” for a subgroup of external investment managers and requiring that plan include a 15 percent participation “goal” (for what the author indicates in supporting material relates to the management of the retirement funds’ total portfolio), SB 294 attempts to guide the Board’s decision making despite its plenary authority and fiduciary mandate under the Constitution.

Staff recommends seeking amendments that allow the Board to establish or retain its own definitions of emerging investment managers and goals regarding emerging manager participation. In addition, staff recommends amendments to ensure that the Board will not be required to take any action that is inconsistent with its fiduciary duties and plenary investment decision-making authority granted by the Constitution as it refines existing programs and strategies as they relate to emerging investment managers.

4. Definition of Emerging Investment Manager Must Be Flexible

While “emerging investment manager” is a commonly used terminology within the investment community and by CalPERS for policy setting and strategic implementation purposes, its meaning varies by asset class. For some investors, it may be defined based on total assets under management, or stage of a firm’s organizational development, or a combination of some or all of these and other factors or characteristics.

Providing a permanent definition of emerging investment manager in regulations may not, therefore, be practicable. In addition, establishing such a definition may also impinge upon the System’s ability to set investment strategies that remain nimble over long periods of time. It would be more efficient to allow the Board the flexibility to establish and amend definitions in the context of planning outside the regulatory process.

5. Legislative Policy Standards

The Board’s Legislative Policy Standards recommend an oppose position on any investment mandate or restriction on the Board’s investment authority. Therefore, consistent with the position the Board took last year on AB 1913 (Davis) staff recommends an oppose, unless amended position then support, once amended. The bill should be amended to include language that states the Board is not required to take any action that is inconsistent with its fiduciary duties and investment decision-making authority granted by the Constitution and allow the Board to define emerging investment managers without going through the regulatory process.

V. STRATEGIC PLAN:

This is not a product of the CalPERS strategic plan, but an ongoing responsibility of the CalPERS Office of Governmental Affairs.

VI. RESULTS/COSTS:

Program Costs

None.

Administrative Costs

Staff estimates annual costs of $100,000 to prepare the proposed report.

DANNY BROWN, Chief
Office of Governmental Affairs

JANINE GUILLOT
Chief Operating Investment Officer

JOSEPH A. DEAR
Chief Investment Officer

PATRICIA K. MACHT
Deputy Executive Officer
External Affairs Branch